

WORLD BANK EAST ASIA AND THE PACIFIC ECONOMIC UPDATE APRIL 2023

REVIVING GROWTH



Summary

Economic activity in most of developing East Asia and Pacific (EAP) has recovered from the recent shocks, with goods exports and private consumption leading the way. However, output remains below pre-pandemic levels in many of the Pacific Island Countries. Inflation remains higher than target ranges in some countries. Near-term growth will depend on: global growth, projected to be slower in 2023 than in 2022, though recent projections are more optimistic; commodity prices, which have moderated; and financial tightening, which is likely to continue in the face of inflationary pressures in the US.

Taking a longer view of the more than two decades since the Asian Financial Crisis (AFC), growth in the developing economies of East Asia and the Pacific has been faster and more stable than in much of the rest of the world. The result has been a striking decline in poverty and, in the last decade, also a decline in inequality. During both the Great Recession and the COVID pandemic, the economies of the region proved more resilient than most.

But it would be a mistake to let these achievements obscure vulnerabilities, past, present, and future. Looking back, sound macroeconomic management after the AFC was accompanied only to a limited extent by productivity-boosting structural reforms. The convergence of the EAP countries with high-income countries, which was previously faster than in other emerging market and developing economies, has recently stalled. Now, the damage done by the pandemic, war, and financial tightening to people, firms, and governments, threatens to reduce growth and increase inequality. The region must cope with these problems even as it faces up to the major challenges of de-globalization, aging and climate change, to which it is particularly susceptible because it has thrived through trade, is growing old fast, and is both a victim of and contributor to climate change.

Four types of policy action are necessary.

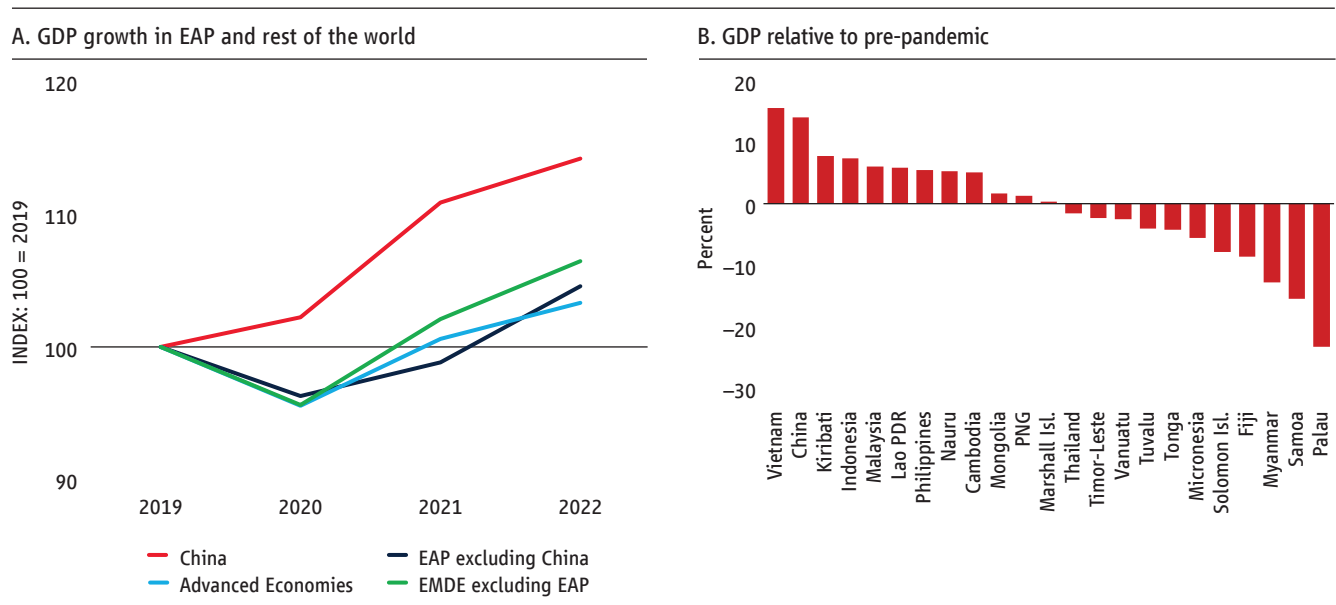
- Macro-financial reforms to support recovery today and inclusive growth tomorrow.
- Structural reforms to boost innovation and productivity across the economy.
- Climate-related reforms to enhance resilience through efficient adaptation.
- International cooperation on climate mitigation, and to ensure openness to trade, investment, and technology flows, ideally multilaterally, but also regionally and bilaterally.

Overview

Recent developments

Most major economies in developing East Asia and Pacific (EAP) have recovered from recent shocks and are growing. However, output remains below pre-pandemic levels in most of the Pacific Island Countries (figure O1).

Figure O1. Most major EAP economies have recovered and are growing, but output in most Pacific Island Countries is still not back to pre-pandemic levels



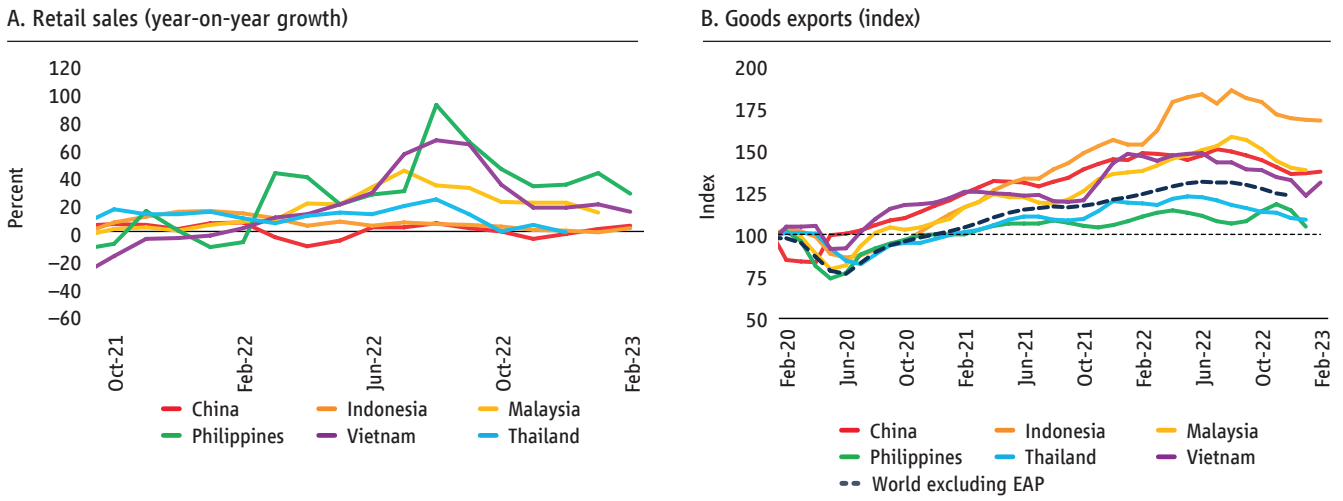
Source: Haver Analytics; World Bank.

Note: B. Bars show the latest quarterly or annual GDP in 2022 relative to 2019 level. EAP: East Asia and Pacific, EMDE: Emerging Markets and Developing Economies.

Growth in the region has been driven primarily by strong private consumption and goods exports. But now there are signs of weakening domestic and foreign demand (figure O2).

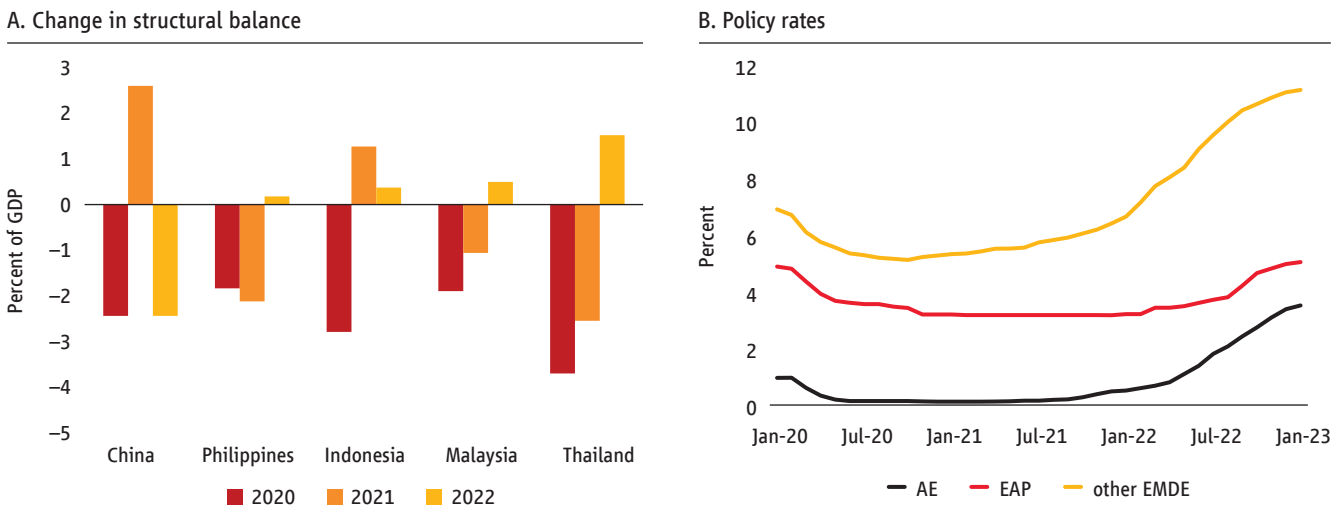
At the same time, macroeconomic policy was becoming less expansionary in most EAP countries. While China provided significant fiscal stimulus in 2022, fiscal support in other countries was diminishing. Even though interest rates were lower in EAP than in other emerging markets and developing economies (EMDEs), they have recently been increasing (figure O3).

Figure O2. Domestic demand is moderating and goods exports are declining



Source: Haver Analytics.
 Note: A. Philippines refers to auto sales. B. Goods export value indexed to 2019 average, seasonally adjusted, 3 month moving average.

Figure O3. Most governments have had less expansionary fiscal policy, and began to tighten monetary policy, in 2022

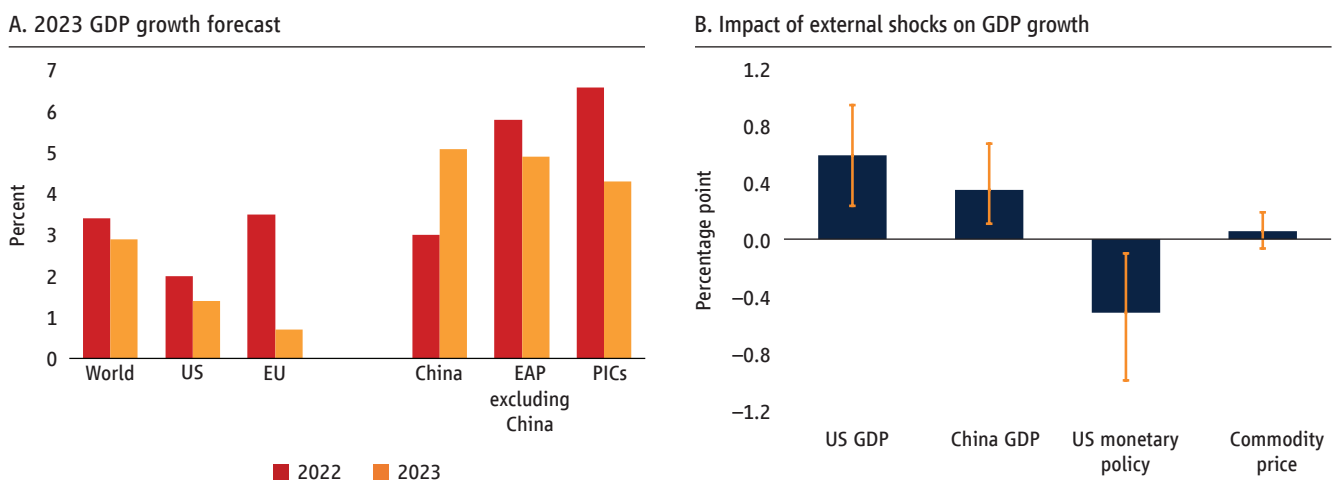


Source: Haver Analytics; World Economic Outlook Database, October 2022.
 Note: B. Figure shows average policy rates in the region. AE: Advanced Economies, EAP: East Asia and Pacific, EMDE: Emerging Markets and Developing Economies.

› Prospects in 2023

Three linked international developments are likely to shape external conditions for EAP economies. First, global growth in 2023 is projected to be slower than in 2022, even though recent projections have become more optimistic (figure O4). The likely slowdown in growth in advanced economies may be partially offset by signs of revival in China’s growth. Second, commodity prices have moderated recently, resulting in declining food and energy prices in several EAP countries. Finally, the continued inflationary pressures in the US are leading to tighter financial conditions not only in the US, but also in the EAP region. To address these inflationary pressures, some countries in the region have raised domestic interest rates, which helped ease capital outflows and depreciation. However, further tightening in advanced economies could renew financial pressures in the region’s economies.

Figure O4. Global growth in 2023 is projected to be slower than in 2022 which, along with monetary tightening, will affect growth in the region



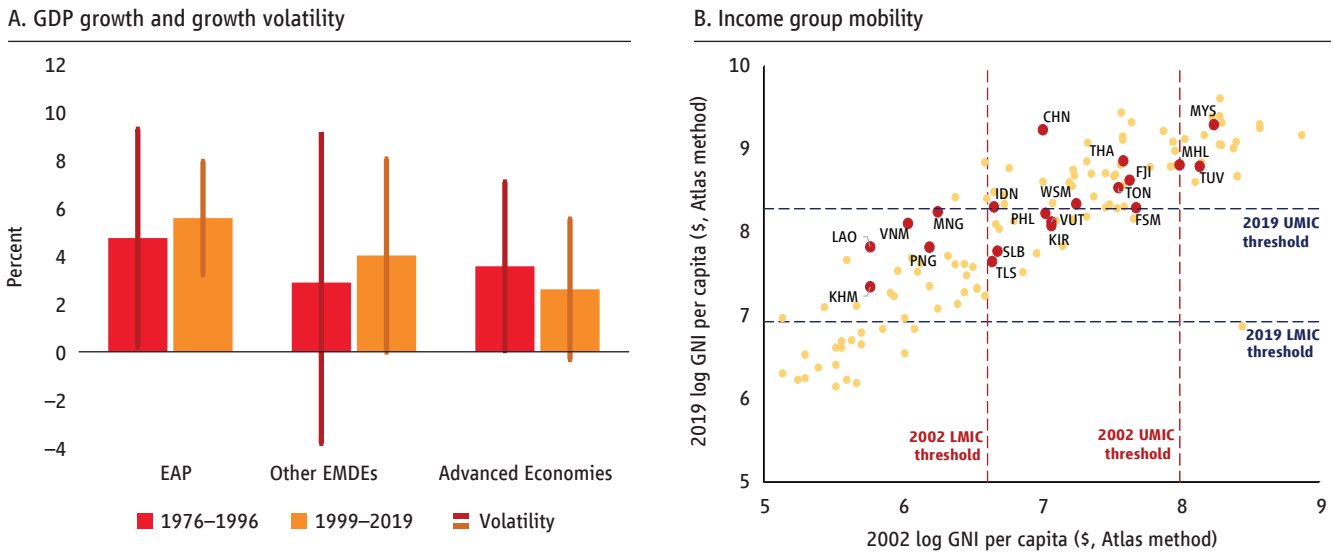
Source: Haver Analytics, International Monetary Fund, World Bank.
 Note: B. Bar shows impact of the following shocks: one percentage point increase in China and US growth, 25 bps increase in US 2-year interest rate yield, and 10 percent increase in commodity prices. EAP: East Asia and Pacific, EU: European Union, PICs: Pacific Island Countries.

› A long view

The countries in the East Asia and Pacific region have experienced two decades of faster and less volatile growth than other economies. During this period, all EAP transitioned to lower or upper middle-income status (figure O5). Behind the stable growth after the Asian Financial Crisis (AFC), was sound macroeconomic management and a history of significant structural reforms. After the AFC, the region saw only limited structural reforms and therefore little productivity-enhancing structural change. In particular, a region that thrived through openness to trade and investment in manufacturing, remained reluctant to liberalize its services sectors.

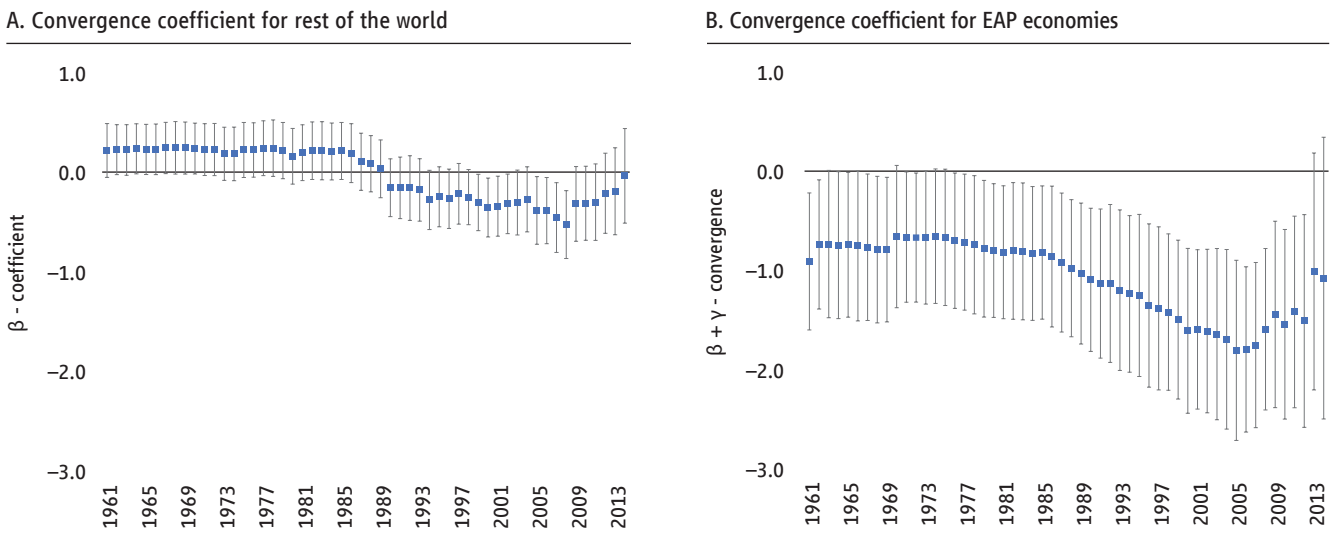
However, the developing EAP catch-up with higher income countries has now stalled. After the Global Financial Crisis and in recent years, convergence has been statistically insignificant (figure O6). At the same time, productivity growth of many EAP economies has been declining (figure O7). The limited growth in labor productivity had been driven more by capital deepening than total factor productivity growth.

Figure O5. EAP countries have seen two decades of higher and less volatile growth than other economies, and all have transitioned either to lower or upper middle-income status



Source: Penn World Tables; World Development Indicators.
 Note: A. Bar height shows average annual growth rate; whiskers show average standard deviation. EAP: East Asia and Pacific, EMDE: Emerging Markets and Developing Economies. B. East Asia and Pacific countries represented by red dots. GNI: Gross National income. LMIC = Lower Middle-Income class, UMIC = Upper Middle-Income class.

Figure O6. EAP convergence with high income countries, which was faster than in other countries, has recently stalled



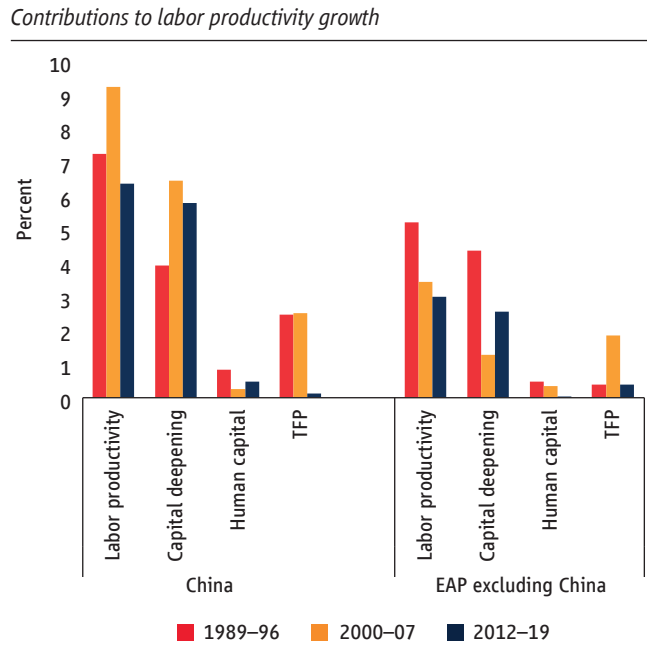
Source: World Development Indicators.
 Note: GDP per capita in PPP. The sample of countries used was restrained to those whose population is larger than one million people. Also, oil-rich countries were excluded.

These trends in growth and productivity have coincided with a shift in the pattern of structural change. At different stages between the 1950s and the late 1990s, the economies in the EAP region saw significant growth in manufacturing. However, between the Asian Financial Crisis and the Global Financial Crisis, the share of manufacturing in GDP peaked and began to decline in the early industrializers. Still-industrializing Cambodia and Vietnam were the exceptions to this trend (figure O8).

The sectoral reallocation of labor underlying this pattern of structural change has not so far favored productivity growth. In Malaysia, Thailand, Indonesia and China, the shift of labor out of agriculture slowed down after the early 2000s, and workers primarily moved not into high productivity manufacturing and business services but into relatively low productivity trade and construction services. The fact that some of the latter services activities were associated with lower productivity in the recent period may reflect the “informalization” and overcrowding of these sectors as they accommodated rural-urban migrants. In Cambodia, Vietnam, and until recently, Myanmar, which are still industrializing, movement out of agriculture was accelerating and oriented towards relatively high productivity manufacturing and services (figure O9).

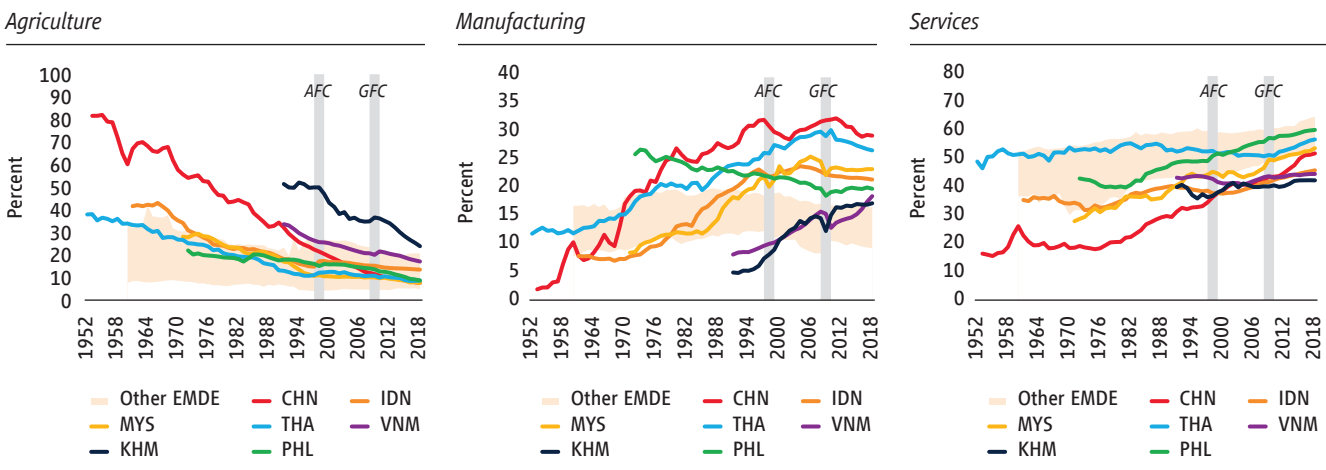
The shift from manufacturing to services need not, however, be antithetical to productivity growth in future. The digital revolution, which received a boost during the pandemic, is transforming services sectors. More services are becoming internationally tradable and the emergence of digital platforms is transforming even domestic services from retail and finance to transport

Figure O7. And productivity growth has been declining



Source: APO Productivity Database, Penn World Tables; World Bank.
 Note: EAP excluding China shows weighted average of ASEAN-4 countries. TFP: Total Factor Productivity.

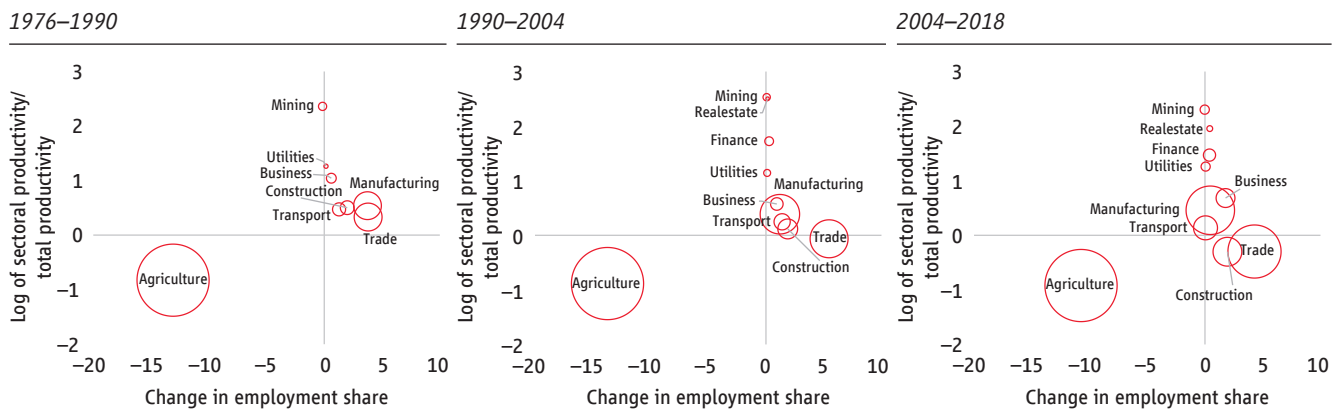
Figure O8. In recent years, the share of manufacturing in GDP declined in major EAP economies (other than Cambodia and Vietnam), and of services in GDP increased



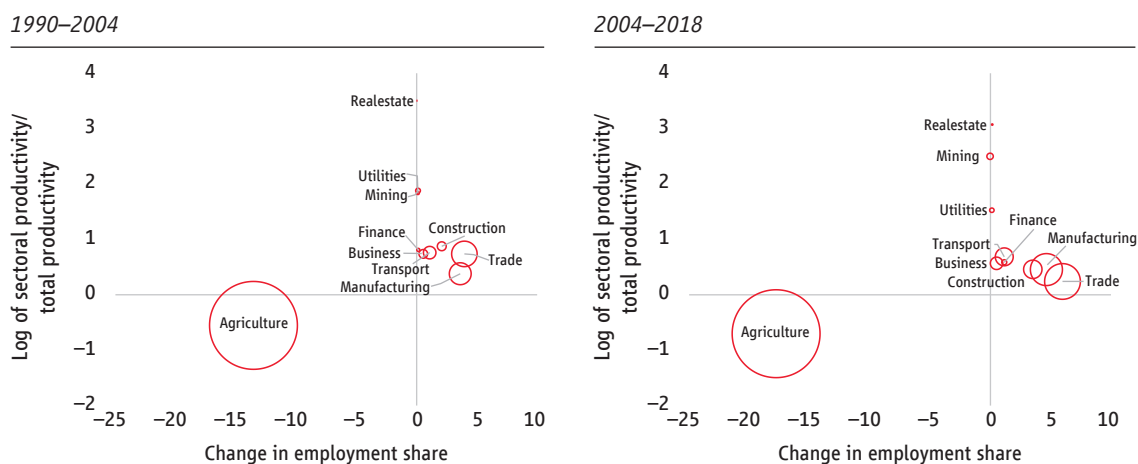
Source: GGDC/UNU-WIDER Economic Transformation Database (Kruse et al., 2022); GGDC 10-Sector Database.
 Note: Figure shows sectoral share in total value-added. Other EMDE shows 25–75 percentile of 20 major Emerging market and Developing Economies outside EAP. AFC: Asian Financial Crisis. GFC: Global Financial Crisis.

Figure O9. In major countries, workers moved mostly from least productive agriculture to below-average productivity services sectors, and not much to the most productive manufacturing and services sectors

A. Group A: EAP countries where increase in manufacturing employment stalled (China, Thailand, Malaysia, Indonesia)



B. Group B: EAP countries where workers were continuing to move to more productive manufacturing and services sectors (Vietnam, Cambodia, and Myanmar)



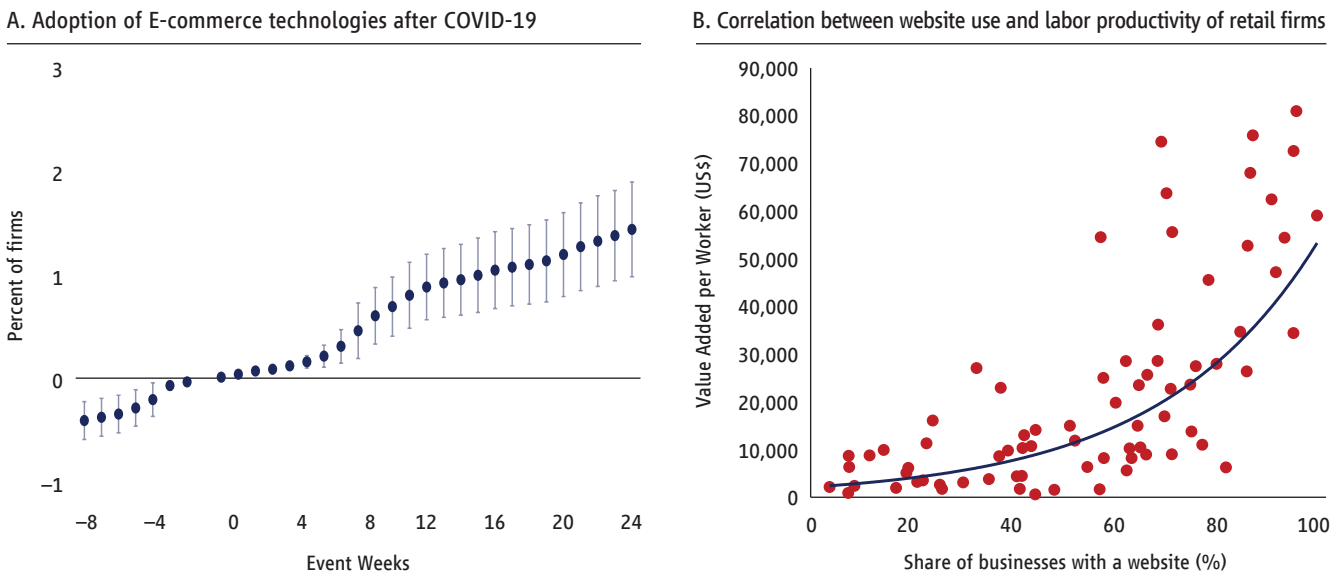
Source: GGDC/UNU-WIDER Economic Transformation Database (Kruse et al., 2022); GGDC 10-Sector Database.
Note: Size of circle represents employment share in the initial year.

and tourism. These changes are contributing to increased productivity in services (figure O10). However, it is not yet clear though whether these changes will lead to an increase in employment not just of the skilled workers but of those with intermediate skills who benefitted enormously from export-led industrialization.

In any case, unleashing new technologies requires market-friendly reforms. EAP economies implemented significant structural reforms, beginning in the early 1980s until the early 2000s. The reforms were broad-based and covered multiple sectors such as manufacturing trade, domestic finance, and product markets, and contributed to per-capita income growth in the region's economies (figure O11).

However, the pace of reforms slowed down in most countries after the early 2000s. To an extent, the slowing reform was a consequence of significant prior liberalization that left limited room for further reforms, especially the political difficult "last mile" improvements in policy. Nevertheless, the latest available data across all reform areas suggest that there are still sizeable gaps in reforms of developing EAP countries relative to a sample of advanced economies, especially in the services sectors that are vital for future growth (figure O12).

Figure O10. The adoption of digital technologies is likely to increase productivity in services



Source: ILOSTAT, UN National Accounts, World Bank Enterprise Surveys, Nayar et al. (2021).
 Note: B. Website data for 2016 or most recent available year.

▸ **Looming challenges**

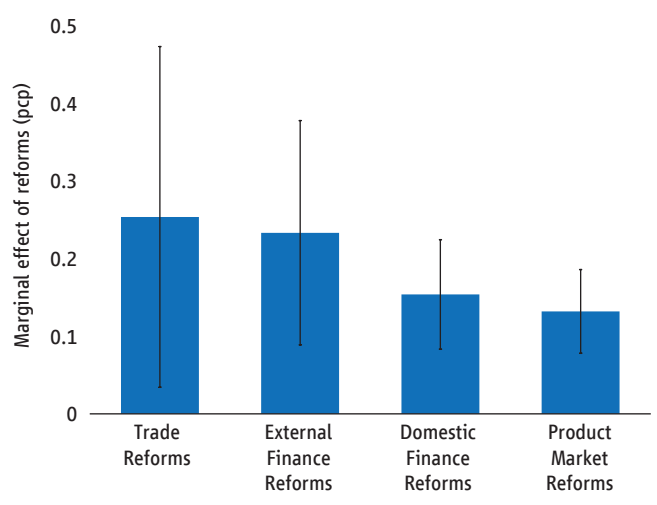
Deeper reforms, more pro-active management and international cooperation are needed especially because the world and the region are changing in ways that pose new challenges to growth. First, a region that reaped enormous benefits from trading in a relatively open, integrated global market governed by predictable trade rules, must now contend with protectionism, trade divisions and policy uncertainty. Second, the regions' previously youthful population is now aging rapidly, affecting labor endowments, pension burdens, and health care needs. Third, the region's fossil fuel-driven growth in a world that was slow to respond to the dangers of climate change, is now threatened by the consequences of global warming, and countries must invest in adaption while contributing to mitigate.

Decoupling?

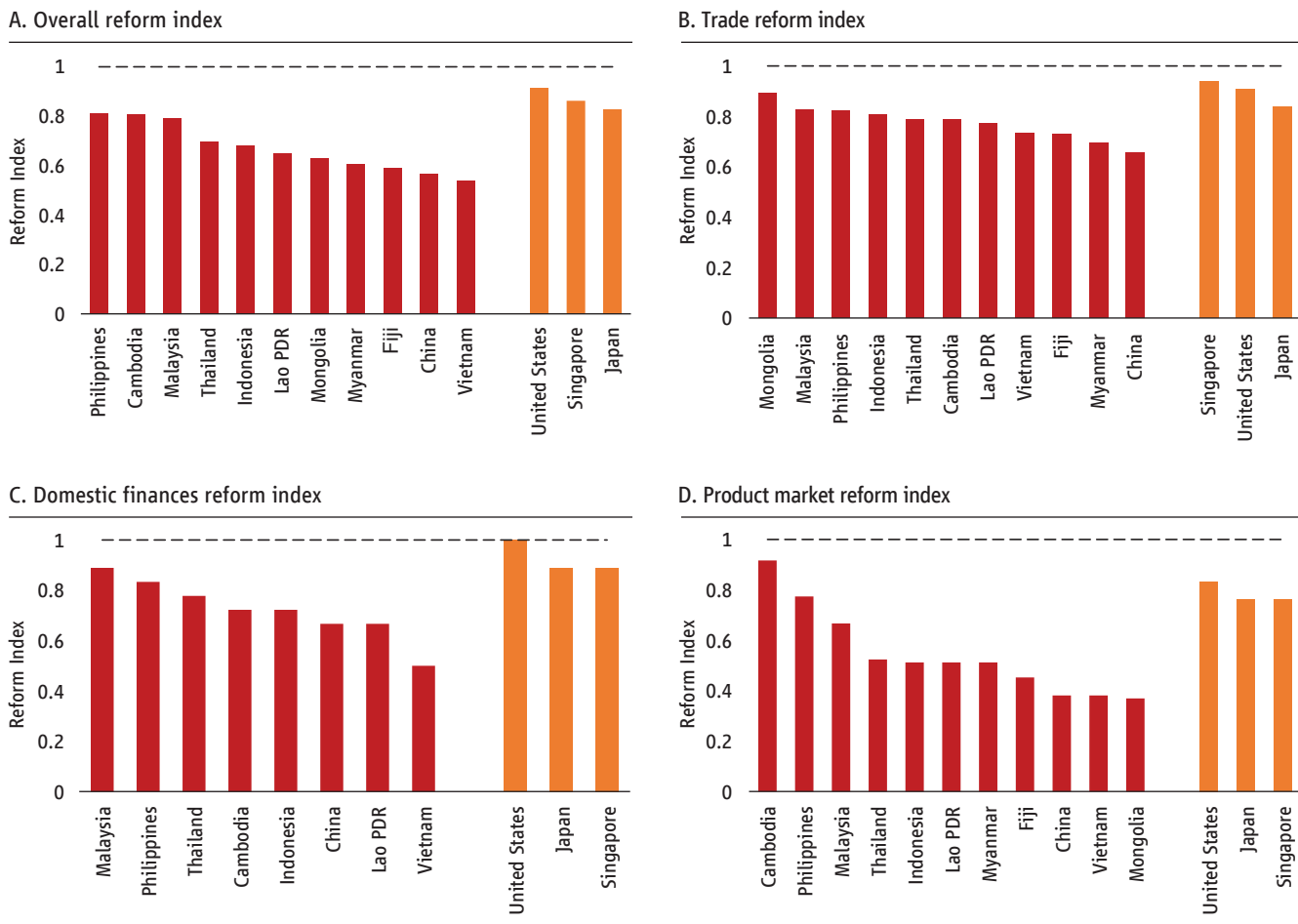
The most immediate challenge for the region is the growing division between its two largest markets. On the face of it, the restrictions on bilateral trade imposed by the US and China could divert trade to third country competitors. However, at least four deeper problems are emerging.

- Politics, rather than economic fundamentals and predictable rules, are molding trade patterns and the resulting uncertainty could discourage investment in other countries.

Figure O11. Reforms contributed positively to GDP-per-capita growth in EAP



Source: World Bank staff's estimates.
 Note: Sectoral reform indices are continuous indicators taking [0-1] value, following Alesina et al. (2020). See text for details.

Figure O12. Countries need to address the significant “reform gap” between EAP and advanced economies

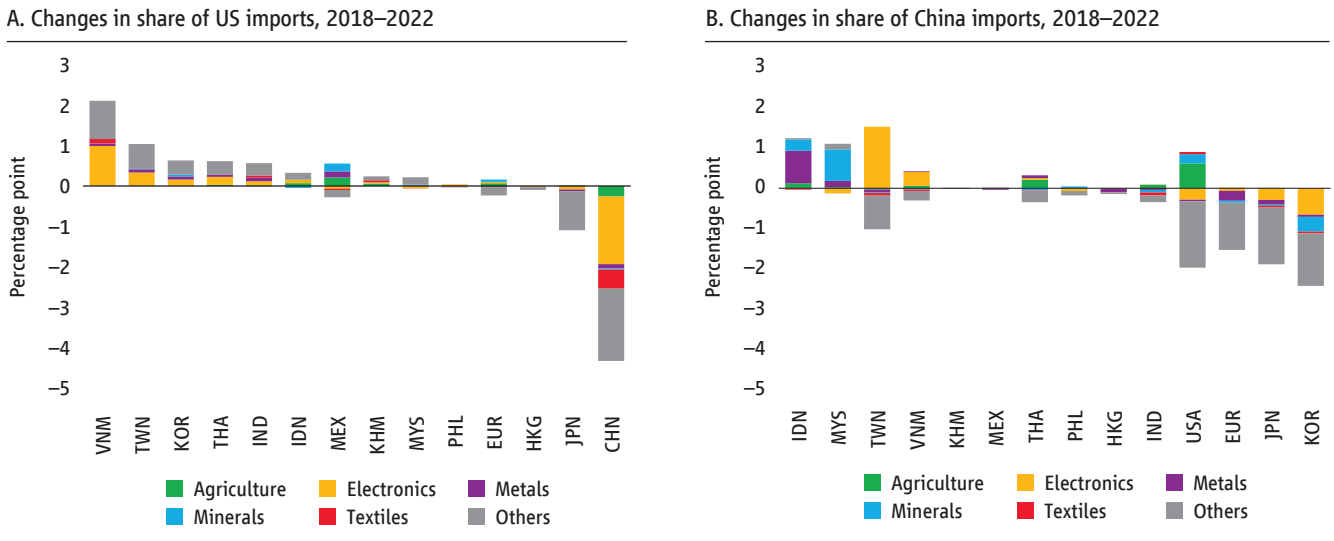
Source: World Bank staff estimates, based on earlier work by Alesina et al. (2020).

Note: Overall and sectoral reform indices are continuous indicators taking a value in the [0-1] interval in 2020. A higher value indicates greater degree of liberalization (lower intensity of restrictions).

- Divergent standards, such as in the differing approach to data flows across locations, could segment markets and prevent third countries from exploiting economies of scale in an integrated global market.
- Export restrictions on ultimate destination, as well as import restrictions on ultimate source, can disrupt GVCs and third country trade.
- Perhaps most seriously, bilateral restrictions on technology flows and collaboration between large countries could reduce the global availability of knowledge.

The increase in bilateral protection is affecting other economies either through trade diversion towards producers of substitute products or through production linkages with suppliers of inputs and complementary products. While China experienced more than a 4-percentage-point decrease in its share of US imports during 2018–2022, with the largest decline in the electronics industry, economies such as Vietnam, Thailand, and Indonesia increased their share of US imports, also particularly in the electronics industry. In contrast, Japan, which has GVC production linkages with both the US and China, saw a slight drop in its share of US imports (figure O13).

Figure O13. Exports of some EAP economies to the US and China increased after they imposition of trade restrictions on each other

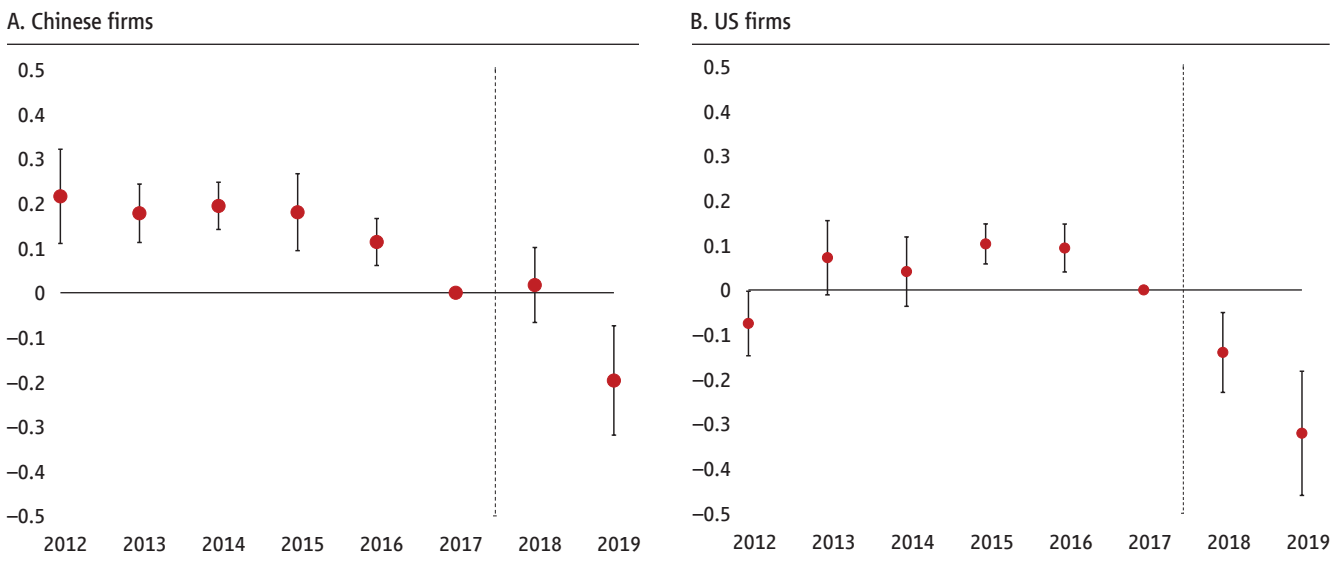


Source: Customs data from the US and China.
 Note: Figure shows sectoral decomposition of changes in the economy's share of respective imports during 2018–2022.

Potentially more important than the impact on trade may be the impact on knowledge. Bilateral restrictions on technology flows and collaboration between large countries could reduce the global availability of knowledge. Initial firm-level evidence suggests adverse effects of recent restrictions on firms in both China and the US (figure O14).

What happens to both Chinese and US innovation matters for other countries in the region. Innovation builds on prior knowledge and backward citations in patents can reflect which sources of prior knowledge are important. While still small

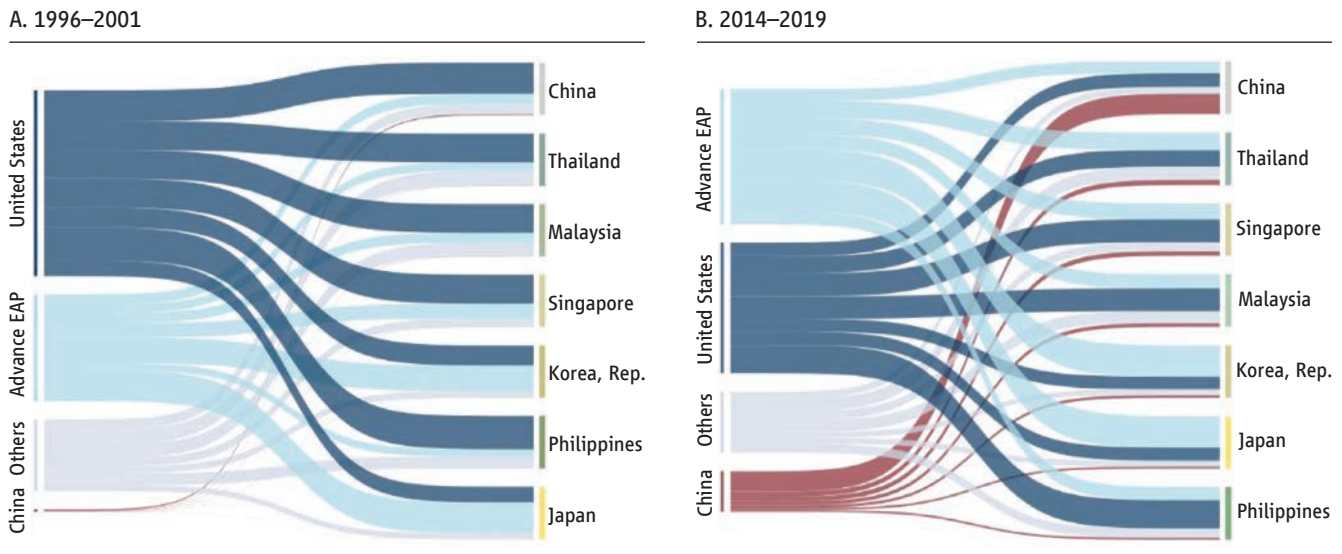
Figure O14. Measures taken after 2018 adversely affected innovation of Chinese firms which had prior collaborations with the US, and of US firms which had prior collaborations with China



Source: Patent applications at EPO, WIPO and USPTO.
 Note: Event study plots of the patent applications of US (Chinese) firms with collaborations before 2018 with inventors in China (US).

compared to the advanced economies like the US, China has become an increasingly important source of knowledge for innovation in other EAP countries, using these citation measures. By 2014–2019, China reflected around 10 percent of the prior knowledge used for Singapore or Thailand innovation (figure O15).

Figure O15. The US and, increasingly, China are important sources of knowledge for other East Asia and Pacific countries



Source: World Bank staff's illustration.

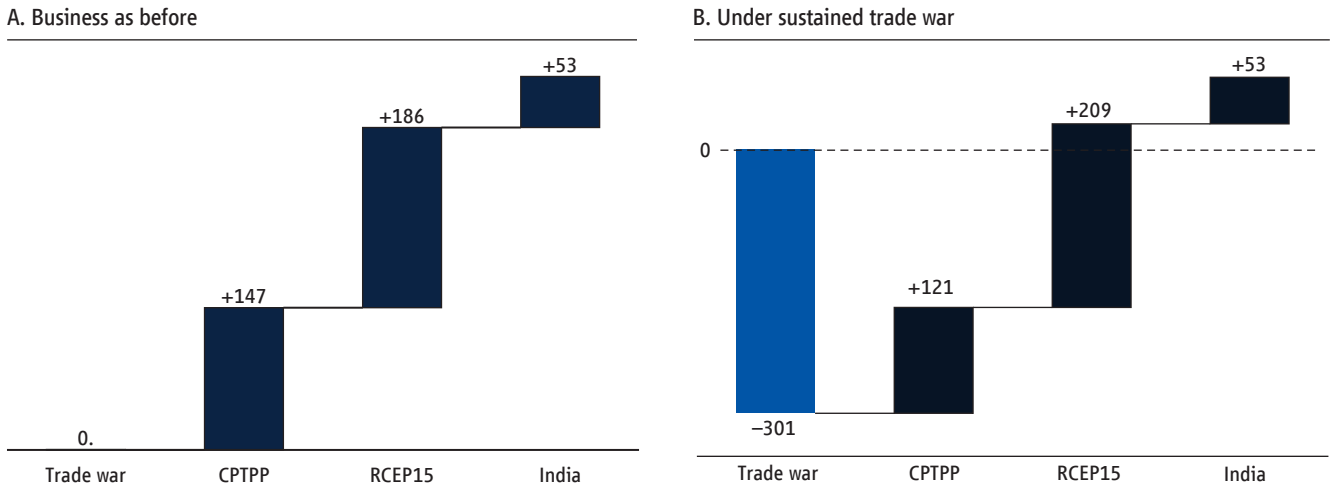
Note: The chart shows the source of backward citations (on the left hand side) for patent applications to EPO/USPTO/WIPO patent offices by assignees in EAP countries (on the right hand side).

How should third countries respond to these developments? A priority should be a reform of their own policies, discussed above, which can enhance their incomes in all states of the world (April 2022 EAP Economic Update (World Bank 2022c)). International agreements can also help. Economic theory suggests that third countries benefit from being “hubs” rather than either “spokes” or members of exclusive trade blocs. That is, a country like Malaysia is better off having trade agreements with both China and the US rather than being left out of any agreement or being part of an exclusive trade bloc. RCEP has helped deepen much of the regions’ integration with China; the CPTPP was meant to but failed to achieve integration with the United States and the proposed Indo-Pacific Economic Framework (IPEF) is not meant to be a traditional trade agreement. Empirical analysis suggests that RCEP and the CPTPP together could more than offset global losses due to the US-China trade war, but not the individual losses of China and the United States, which risk becoming “spokes” because of the growing economic distance between them (figure O16).

Aging

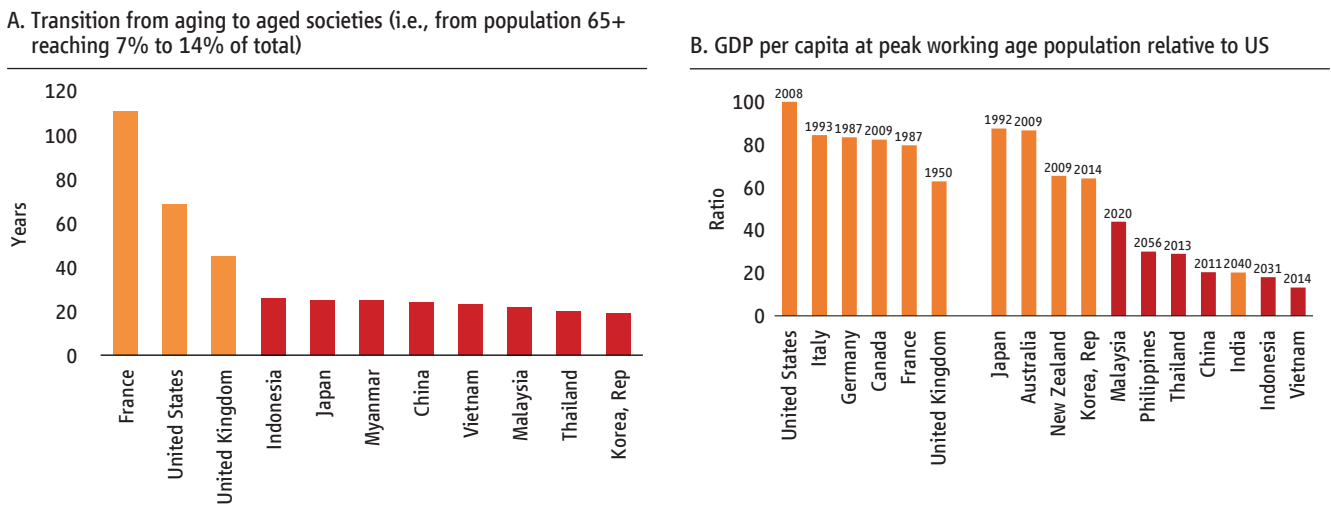
The EAP region is also facing the economic challenge of aging faster and at lower levels of income than the currently richer and older OECD and ECA countries. The transition from aging to aged societies (i.e., from reaching 7% of total population 65+ to 14% in that cohort) is taking only 20–25 years for most East and Southeast Asian countries, in contrast to 50–100+ years in those other countries. EAP countries are also becoming aged societies at far lower income levels than their OECD counterparts, with PPP per capita GDP at peak working age shares between 10 and 40% of the level of the United States at the same point in demographic transition (figure O17).

Figure O16. The adverse effects of a trade and technological rift between large countries can be reduced by third countries forming (separate) trade agreements that ideally include each large country



Source: Drawing on Petri and Plummer (2020).
 Note: Bars depict changes in global income (billion US\$) by 2030. "Business as before" assumes a return to a pre-trade war path. "Sustained trade war" assumes path defined by post-phase one tariffs. Bars show incremental effects of adding each policy to all previous policies. The policy denoted "India" involves adding India to the RCEP15 agreement to form RCEP16. CPTPP: Comprehensive and Progressive Agreement for Trans-Pacific Partnership. RCEP: Regional Comprehensive Economic Partnership.

Figure O17. EAP countries are aging faster than rich countries did, and the working age population will peak at lower levels of income per capita

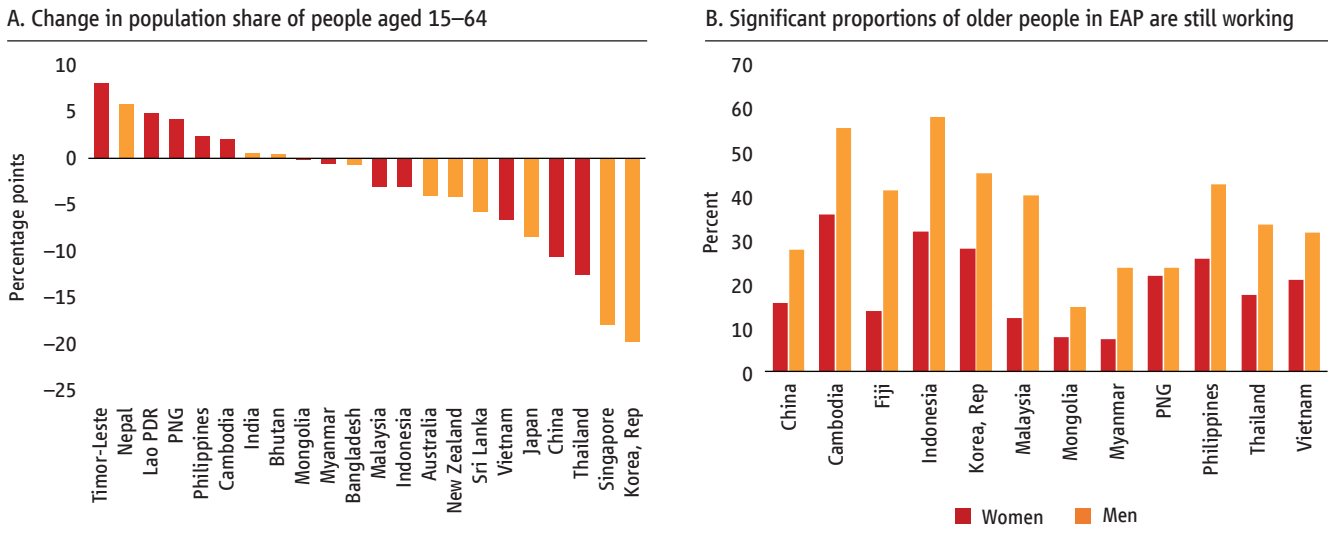


Source: UN Population projections, 2022, medium fertility variant.
 Note: A. Bars denote years realized or projected for the 65+ share of population to go from 7% to 14% of total population. B. Bars denote realized or projected GDP per capita relative to the US when working age population (15–65 cohort) reaches peak.

Aging

Population aging may impact economic growth through the decline in the share of the working age population (typically defined as the population age 15–64; figure O18). However, measures to encourage and help older people work could lessen the adverse impact.

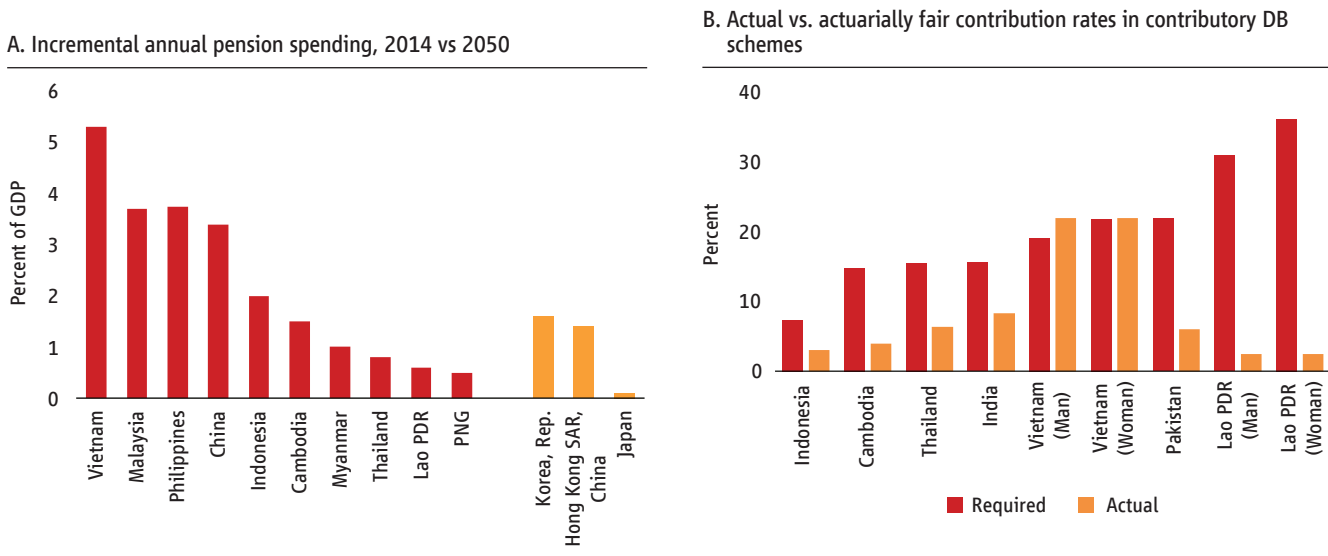
Figure O18. Aging could reduce the share of the conventional “working age” population, unless older people (especially women) continue to work



Source: ILO 2022 LHS and WHO RHS.

Population aging could also strain fiscal balances on both the revenue and expenditure sides. On the expenditure side, the pressures on public finances will come from rising pension costs, health and long-term care spending, with the first the most pronounced. On the revenue side, the declining size of working age population will shrink the contribution base from which pension, unemployment, and health insurance systems are financed in several major economies in the region. A solution is to increase current contribution rates and bring them closer to actuarially fair rates (figure O19).

Figure O19. Aging will increase spending on pensions, and requires bridging the gap between actual and actuarially fair contribution rates



Source: World Bank 2016a.

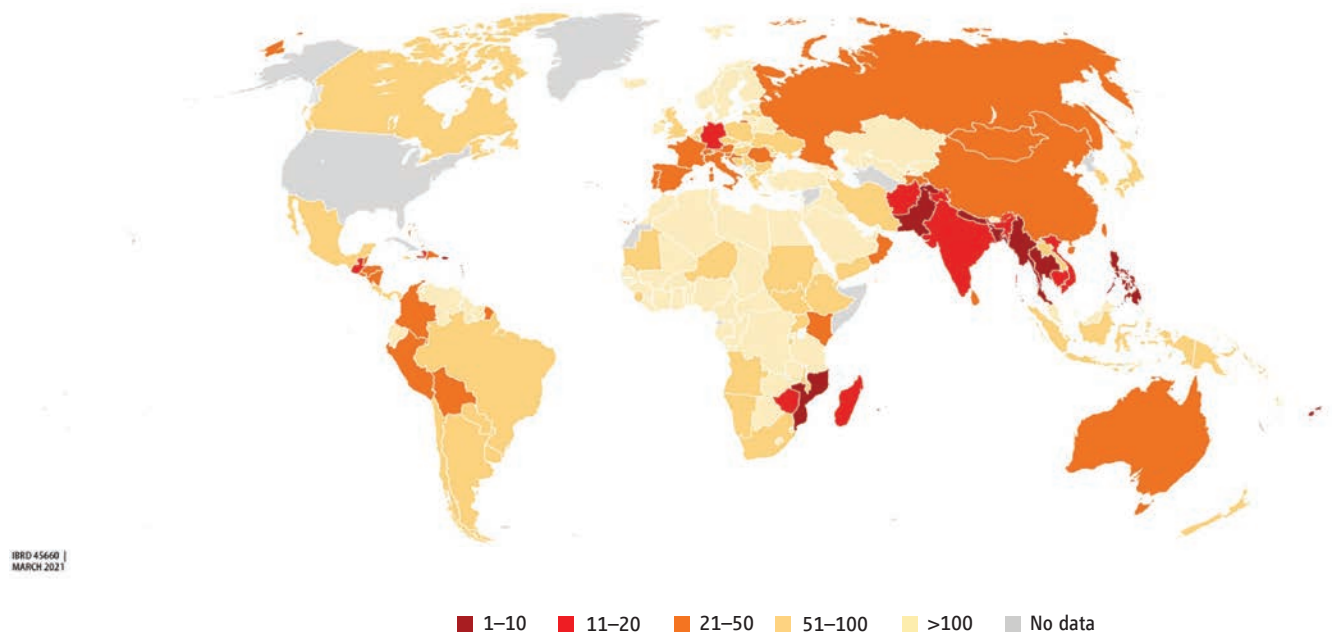
Aging is also likely to drive up health and aged-care spending over time, but the public spending impacts are likely to be more modest, as aging is a less significant driver of healthcare costs. But aging populations with higher non-communicable disease (NCD) prevalence and higher co-morbidities will accelerate the epidemiological transition. Structural reforms in the health sector will be needed to better prevent, control and manage NCDs across the lifecycle.

› **Adapting to climate change**

The EAP region is particularly exposed to climate risks, in part because of the high density of population and economic activity along the coasts. More than half of the annual losses from natural disasters worldwide occur in EAP (figure O20). Without major adaptation efforts, coastal, river, and chronic flooding alone could lead to GDP losses of 5–20 percent by 2100 in Indonesia, Vietnam, the Philippines, and China. Climate impacts are most pronounced across the PICs, where natural disasters are estimated to already cost the region over 2 percent of GDP every year and sea level rise is likely to threaten the existence of entire low-lying atoll island nations (Kiribati, Marshall Islands and Tuvalu).

Figure O20. EAP countries are highly exposed to climate change impacts

Climate Risk Index Ranking (1999–2019)

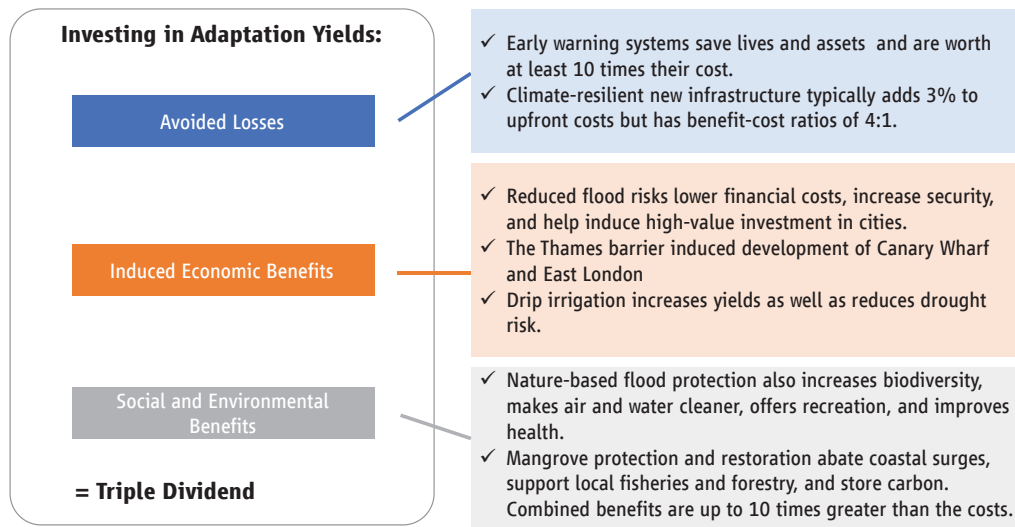


Source: Germanwatch.

The first pillar of climate adaptation is risk reduction, such as ex ante investments in infrastructure and agriculture, and policies to reduce risk such as regulating against construction in flood-prone areas and protecting nature that stabilizes hillsides and protect cities from storm surges. The second pillar are measures to manage risk, ranging from early warning systems to sovereign risk insurance and social safety nets. Inherent in how governments assess these options is incorporating measures to incentivize private sector cost-sharing to the extent possible.

Globally and in EAP, there is under-investment in climate adaptation. Recent more detailed analysis of a range of adaptation investments shows that the returns on investment in adaptation can be much greater than simply the avoided losses. This analysis, referred to as the triple dividends, uses cost-benefit analysis (CBA) to properly estimate avoided losses (first dividend), induced economic or development benefits (second dividend), and additional social and environmental benefits (third dividend) of adaptation actions (figure O21).

Figure O21. Investing in adaptation will deliver a triple dividend



Source: World Bank staff's illustration.

Empirical analysis of adaptation investments shows that each dividend is often significant. Recent analysis of seven different projects targeting different categories of climate change impacts — forests and wildfires, urban flooding and drainage, stormwater management, coastal flooding, urban heat islands, and drought — shows that in all cases, valuing the three dividend types makes a significant difference in assessing total project benefits (table O1).

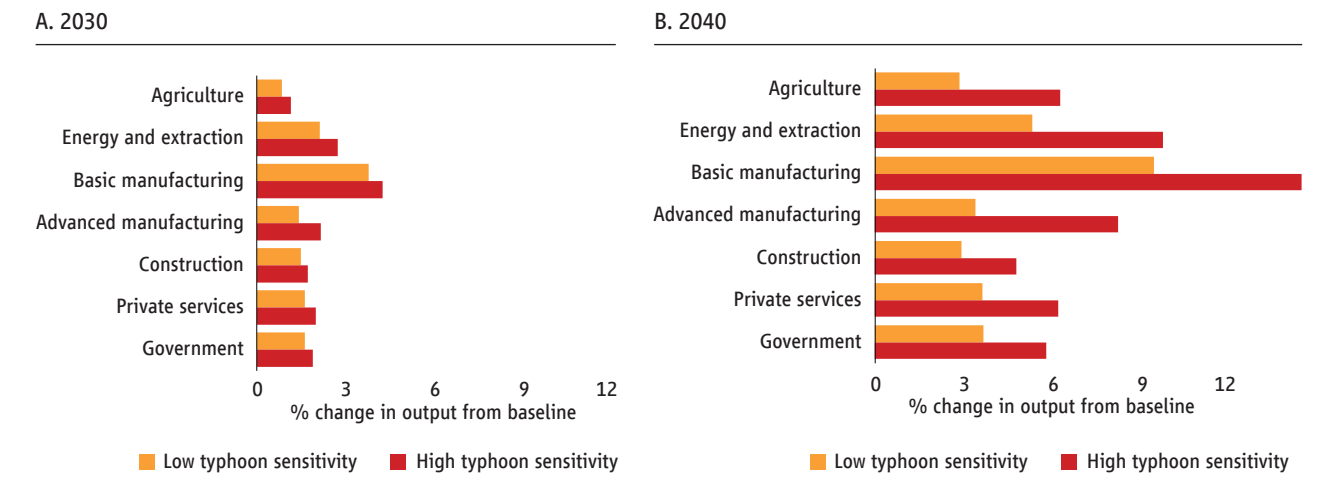
Table O1. Valuing the triple dividend reveals the high returns to investment in different adaptation projects

	<i>Forests and wild fires</i>	<i>Urban flooding and drainage</i>	<i>Stormwater management</i>	<i>Coastal flooding</i>	<i>Urban heat islands (Two U.S. cities in one study)</i>		<i>Drought</i>
	Tahoe National Forest (United States)	Kunshan Forest Park (China)	Princes Park (Australia)	Felix stowe (United Kingdom)	Washington, DC	Philadelphia	Ningxia (China)
Project cost (US\$ million)	4	12	6.7	20.3	838	2,380	1,970
Project benefits (US\$ million)	22.9	59.7	12.7	644.9	5,750	10,780	11,050
Benefit-cost ratio	5.7	49.6	1.9	31.8	6.9	4.5	5.6

Source: World Resources Institute, 2022.

At the sector and macro levels, the benefits of adaptation investments are clear. For example, in Samoa, investing an additional 2 percent of GDP in adaptation for the next five years would save about 4.5 percent of 2021 GDP in output losses. In the Philippines, all sectors would benefit from climate adaptation measures: investments of less than 1% of GDP would avoid losses of 1–2% of GDP in many sectors (figure O22).

Figure O22. For example, all sectors will benefit from adaptation investments in the Philippines



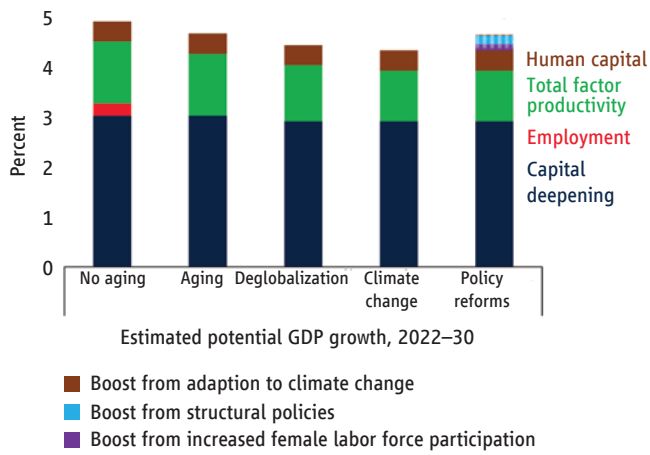
Source: World Bank Philippines Country Climate and Development Report (CCDR), 2022.

While decoupling, aging and climate change can reduce potential growth, structural reforms and climate adaptation can offset the adverse impact. Policies that foster competition and allow for the mobility of labor and capital across different sectors could lead to productivity gains. Similarly, policies that reduce trade costs and improve the efficiency of financial and capital markets could stimulate investment and capital formation. Implementing such policies, under reasonable assumptions, could increase potential GDP growth by 0.15 percentage point annually. Increasing labor force participation could add another 0.28 percentage point annually to potential growth. Moreover, adapting to climate change could mitigate the adverse impacts of climate change on total factor productivity growth and add another 0.1 percentage point per year to potential GDP growth over the next decade (figure O23).

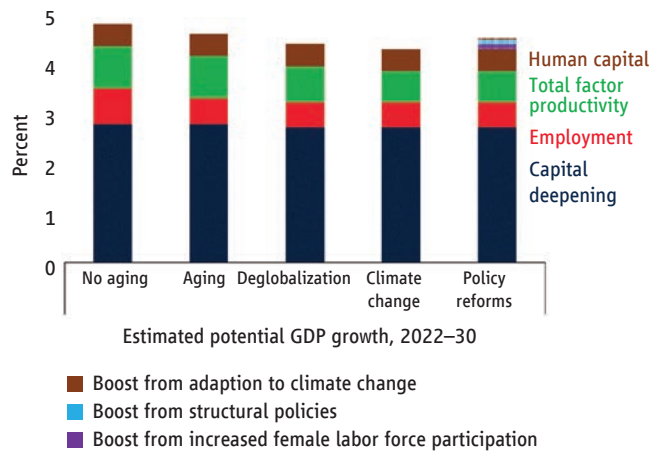
Figure O23. Aging, deglobalization and climate change can reduce potential growth, but reforms can offset the impact

Potential GDP growth

A. EAP



B. EAP excluding China



Source: World Bank staff's estimates.

